

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF SPANISH COVE)	
SANITATION SYSTEM, INC. FOR A RATE)	
ADJUSTMENT PURSUANT TO THE)	CASE NO. 96-266
ALTERNATIVE RATE FILING PROCEDURE)	
FOR SMALL UTILITIES)	

O R D E R

On July 29, 1996, Spanish Cove Sanitation System, Inc. ("Spanish Cove") filed its application for Commission approval of proposed sewer rates. Commission Staff, having performed a limited financial review of Spanish Cove's operations, has prepared the attached Staff Report containing Staff's findings and recommendations regarding the proposed rates. All parties should review the report carefully and provide any written comments or requests for a hearing or informal conference no later than 15 days from the date of this Order.

IT IS THEREFORE ORDERED that all parties shall have no more than 15 days from the date of this Order to provide written comments regarding the attached Staff Report or requests for a hearing or informal conference. If no request for a hearing or informal conference is received, this case will be submitted to the Commission for a decision.

Done at Frankfort, Kentucky, this 18th day of March, 1997.

ATTEST:



Executive Director

PUBLIC SERVICE COMMISSION



For the Commission

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

THE APPLICATION OF SPANISH COVE)	
SANITATION SYSTEM, INC. FOR A RATE)	
ADJUSTMENT PURSUANT TO THE)	CASE NO. 96-266
ALTERNATIVE RATE FILING PROCEDURE)	
FOR SMALL UTILITIES)	

STAFF REPORT

Prepared By: Carl Salyer Combs
Public Utility Financial
Analyst, Senior
Water and Sewer Revenue
Requirements Branch
Financial Analysis Division

Prepared By: Christopher H. Smith
Public Utility Rate
Analyst
Communications, Water and
Sewer Rate Design Branch
Rates and Research Division

STAFF REPORT

ON

CASE NO. 96-266

A. Preface

On July 29, 1996, Spanish Cove Sanitation System, Inc. ("Spanish Cove") filed an application with the Commission seeking to increase its sewer rates pursuant to the Alternative Rate Filing Procedure for Small Utilities. The proposed rates would generate approximately \$19,036 annually in additional revenues, an increase of 45.1 percent over normalized test-year revenues of \$42,229.

In order to evaluate the requested increase, the Commission Staff ("Staff") chose to perform a limited financial review of Spanish Cove's operations for the test period, calendar year 1994. Since Spanish Cove requested and received Staff assistance in preparing this application, the field review was done prior to the filing of the application. Carl Salyer Combs conducted the review on March 27, 1996, at the home of John Lawson, Spanish Cove's owner. Mr. Combs is responsible for this Staff Report except for the section on operating revenues which was prepared by Christopher H. Smith of the Commission's Division of Rates and Research.

During the course of the review, Spanish Cove was informed that all proposed adjustments to test-year expenses must be supported by some form of documentation, such as an invoice, or that all such adjustments must be known and measurable. Based upon the findings of this report, Staff recommends that Spanish Cove be authorized an increase of \$3,399 in its normalized annual operating revenues.

Scope

The scope of the review was limited to obtaining information to determine whether reported test-period operating revenues and expenses were representative of normal operations. Insignificant or immaterial discrepancies were not pursued and are not addressed herein.

B. Analysis of Operating Revenues and Expenses

Operating Revenues

Spanish Cove's 1994 annual report reflects revenue from rates during the test period of \$42,220. However, during review of the billing information provided by Spanish Cove, Staff discovered that Spanish Cove was charging certain commercial customers rates in excess of those approved in the utility's current tariff. Thus, in normalizing the revenue from rates, Staff has used only the approved rates for Spanish Cove. A calculation of its revenue from approved rates for 1994 based upon its year-end number of customers yields a normalized revenue of \$42,229 an increase of \$9 over reported test year revenue.

Operating Expenses

Spanish Cove incurred, and the Staff-assisted application included, test-period operating expenses of \$66,846. Spanish Cove proposed to reduce that amount by \$12,993. Spanish Cove's proposed adjustments and Staff's recommendations are discussed in the following sections:

Management Fee

Spanish Cove reported no test-year management fee, but proposed an annual fee of \$3,600. The Commission's normal practice in cases involving small sewer utilities is to allow an annual management fee. The management duties of Spanish Cove's owner/manager are comparable to the general oversight responsibilities of a water district commissioner. According to KRS 74.020 (6), a water district commissioner shall receive annual compensation of not more than \$3,600. Staff is of the opinion that such an amount is appropriate in this instance and recommends inclusion of an annual management fee of \$3,600 for rate-making purposes.

Other - Labor, Materials and Expenses

Spanish Cove reported test-year other - labor, materials and expenses of \$4,279 related to testing to comply with Kentucky Pollution Discharge Elimination System ("KPDES") requirements. A review of invoices for testing revealed that the test-year monthly expense was \$225. Therefore, Staff recommends that annual other - labor, materials and expenses (testing) of \$2,700¹ be included for rate-making purposes.

Electric Expense

Spanish Cove reported test-year electric expense of \$8,265. A review of invoices from Louisville Gas and Electric showed a total of \$5,784. Therefore, Staff recommends that annual electric expense of \$5,784 be included for rate-making purposes.

¹ \$225 per month x 12 months = \$2,700

Chemicals Expense

Spanish Cove reported test-year chemicals expense of \$4,769, but proposed to reduce that amount by \$3,235 to reflect a more typical level of expense, specifically to match the 1995 chemicals expense which totaled \$1,631. Since Staff's goal is to arrive at a total level of operating expense that reflects a normal or typical year's operating experience, Staff agrees with Spanish Cove's proposed adjustment. Therefore, Staff has included annual chemicals expense of \$1,631 for rate-making purposes.

Routine Maintenance Fees

Spanish Cove reported no test-year routine maintenance expense. However, at the time of the field review, Staff discovered that \$6,247 charged to Account No. 710-B -- Internal Supervision and Engineering was inadvertently shown on the wrong line in the annual report. That amount should have been listed on the line just above in the annual report, the line on which routine maintenance expense would normally have been shown. In support of routine maintenance expense, Spanish Cove provided invoices from Eubank, Hall and Associates, Inc. of Louisville, Kentucky, for early 1996 which reflect a monthly charge of \$650 for provision of routine maintenance services. Since this expense is known and measurable, Staff recommends inclusion of annual routine maintenance expense of \$7,800² for rate-making purposes.

² \$650 per month x 12 months = \$7,800 annually

Internal Supervision and Engineering Expense

Spanish Cove reported test-year internal supervision and engineering expense of \$6,247. As discussed in the preceding section on routine maintenance, the \$6,247 was inadvertently recorded on the wrong line of the annual report. Therefore, Staff has included no annual internal supervision and engineering expense for rate-making purposes.

Maintenance of Treatment Plant

Spanish Cove reported test-year maintenance of treatment plant expense of \$22,810. While conducting the field review, Staff asked whether any expenses of an extraordinary or non-recurring nature had been incurred during the test year. Spanish Cove did not indicate at that time that any such expenses had been incurred. However, in the Commission's Order of December 6, 1996, Spanish Cove was requested to provide the total amount of all test-year expenditures of a non-recurring nature. In its response to that request, filed with the Commission on January 27, 1997, Spanish Cove showed that \$16,508 of the reported \$22,810 was for non-recurring lagoon repairs. Staff is of the opinion that the \$16,508 non-recurring cost should be excluded as an annual expense for rate-making purposes. This amount will be addressed further in a succeeding section on amortization expense. The remaining \$6,302 exceeds reported 1995 annual maintenance of treatment plant expense of \$4,419. Based upon its review of test-year maintenance invoices, Staff accepts the remaining expense of \$6,302 and recommends that annual maintenance of treatment plant expense of \$6,302 be included for rate-making purposes.

Outside Services Expense

Spanish Cove reported test-year outside services expense of \$12,221, but proposed to reduce that amount by \$10,791 to reflect a more typical level of expense. All but \$930 (for accounting expense) of the test-year charges were for legal services, and Mr. Lawson had an unusually high level of legal expense during the test year due to extraordinary legal problems. According to Spanish Cove's accountant, normal legal expense runs about \$500 annually. Therefore, Staff recommends inclusion of annual outside services expense of \$1,430 (\$500 for legal and \$930 for accounting) for rate-making purposes.

Amortization Expense

As mentioned previously in the section on maintenance of treatment plant, Staff is of the opinion that the reported test-year \$16,508 expense of a non-recurring nature should be excluded as an annual expense for rate-making purposes. Staff is further of the opinion that this amount should be amortized over an appropriate period. Larry Updike, a sewer plant inspector with the Commission's Engineering Division is of the opinion that 10 years is an appropriate period over which to amortize such an expense. Therefore, Staff recommends that annual amortization expense of \$1,651³ (related to the non-recurring lagoon repairs) be included for rate-making purposes.

Operations Summary

Based on the recommendations of Staff contained in this report, Spanish Cove's operating statement would appear as follows:

³ \$16,508/10 years = \$1,651

	<u>Test Period Application</u>	<u>Recommended Adjustments</u>	<u>Test Year Adjusted</u>
OPERATING REVENUES	\$ 42,220	\$ 9	\$ 42,229
<u>OPERATING EXPENSE:</u>			
Mgmt. Fee	\$ -0-	\$ 3,600	\$ 3,600
Other Labor,			
Mat. (Testing)	4,279	(1,579)	2,700
Electric Power	8,265	(2,481)	5,784
Chemicals	4,769	(3,138)	1,631
Routine Maint.	-0-	7,800	7,800
Internal Super.	6,247	(6,247)	-0-
Maint. of Treat.			
Plant	22,810	(16,508)	6,302
Office Supplies	673	-0-	673
Outside Srvcs.	12,221	(10,791)	1,430
Insurance	795	-0-	795
Depreciation	6,635	-0-	6,635
Amortization	-0-	1,651	1,651
Taxes Other Than			
Income Taxes	<u>152</u>	<u>-0-</u>	<u>152</u>
Total Operating Exp.	\$ <u>66,846</u>	\$ <u>(27,693)</u>	\$ <u>39,153</u>
NET INCOME	\$ <u>(24,626)</u>	\$ <u>27,702</u>	\$ <u>3,076</u>

C. Revenue Requirements Determination

The approach frequently used by the Commission to determine revenue requirements for small, privately-owned utilities is the calculation of an operating ratio.⁴ This approach is used primarily when there is no basis for a rate-of-return determination

⁴ Operating Ratio = Operating Expense/Operating Revenue

or due to the fact that the cost of the utility plant has been recovered fully, or largely, through the receipt of contributions, either in the form of grants or donated property. As Spanish Cove fits this description, Staff recommends use of an operating ratio for determining revenue requirements. The ratio generally used by the Commission in order to provide for equity growth is 88 percent. In this instance, use of an 88 percent after-tax operating ratio applied to the adjusted test-period operating expense of \$39,153 results in a total revenue requirement of \$45,628, an increase of \$3,399 over normalized test-year revenues of \$42,229. Therefore, Staff recommends an increase of \$3,399 in annual revenues.

D. Rate Design

Spanish Cove has three customer classes: 1) residential, 2) multi-family (per dwelling unit), and 3) commercial. Sewer rates are generally based on the amount of plant capacity allocated to each customer classification. This allocation determines whether the sewer plant is operating at full capacity. Since a treatment plant which is operating at full capacity cannot add new customers, the allocation of plant capacity ultimately affects operating revenues and rates.

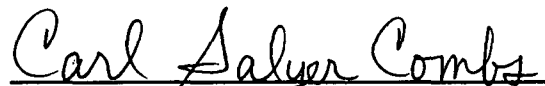
In allocating plant capacity, the Commission follows generally accepted wastewater usage criteria. Residential customers are allocated 400 gallons per day or 12,000 gallons per month (75 percent of the residential allocation). Apartment units are allocated 300 gallons per day or 9,000 gallons per month. The rates for commercial customers and other large users are based on a residential equivalent 12,000 gallons. Therefore, a commercial

customer who used 26,000 gallons would be billed at a rate of 2.17 times the residential rate. A residential equivalent should not be rounded to the next whole number.

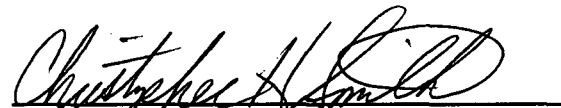
In establishing new rates for Spanish Cove, the Commission has used this methodology. Residential and apartment buildings will be charged a fixed rate. The rate for apartment buildings is 75 percent of the residential rate. Commercial customers will be charged a rate per residential equivalent. The usage for commercial customers should be reviewed on at least an annual basis to ensure that the residential equivalent used in calculating the bill is accurate.

The rates in Appendix A will meet the recommended revenue requirement of \$45,628. Appendix B shows the amount to be assessed to each customer based on 1994 usage.

E. Signatures



Prepared By: Carl Salyer Combs
Public Utility Financial
Analyst, Senior
Water and Sewer Revenue
Requirements Branch
Financial Analysis Division



Prepared By: Christopher H. Smith
Public Utility Rate Analyst
Communications, Water and
Sewer Rate Design Branch
Rates and Research Division

APPENDIX A
TO STAFF REPORT IN CASE NO. 96-266

Rates: Monthly

Residential	\$14.94
Apartments (per unit)	11.21
Commercial	14.94 per Residential Equivalent ¹

¹A residential equivalent is defined as 12,000 gallons or fraction thereof.

APPENDIX B
TO STAFF REPORT IN CASE NO. 96-266

<u>Classification</u>	<u>Units</u>	<u>Rate</u>	<u>Revenue</u>
Residential	87	\$14.94	\$15,597
Apartments (per unit)			
5500 Delmaria Way	12	11.21	1,614
5502 Delmaria Way	12	11.21	1,614
Fireside Properties, Inc.	4	11.21	538
SM.V. Properties	20	11.21	2,690
Hurstbourne Terrace	72	11.21	9,685
Hurstbourne Gardens	48	11.21	6,454
Commercial (R.E.'s)			
Captain D's	2.3	34.36 ²	412
T.K. Pub	4.3	64.24	771
Jefferson Animal Hospital	1.0	14.94	179
Red Cap Cleaners	5.3	79.18	950
Concord Custom Cleaners	6.3	94.12	1,129
Winn-Dixie	5.2	77.69	932
Baumgardner-Hogan	16.3	243.52	2,922
Premier Video	1.0	14.94	179
Total Annual Revenue			\$45,666

²Rate equals the residential rate times the number of residential equivalents used.